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ABSTRACT

Alaska became suddenly and surprisingly rich in the early 1980s, with oil revenues from Prudhoe Bay paying for almost all state operations, picking up some of the costs of local government, creating a huge state savings account, paying all Alaskans annual cash dividends, and eliminating the need for state personal income taxes. The smaller projected petroleum revenues of the 1990s will mean cutting the state's budget. To make budget decisions, Alaskans need to know how the state actually spent its money in the 1980s, and they need to keep in mind that before the oil riches, Alaska's state government spending was two to three times the national average. Other factors to consider are the doubling of population between 1967 and 1987 and inflation that nearly tripled prices. The gap between Alaska's state spending and the average for other states widened in the 1980s because, with its increased revenues, Alaska (1) expanded existing programs; (2) delivered services in more expensive ways; (3) added many new kinds of spending; and (4) increased wages of public employees. These steps created economic and political forces that will complicate balancing the state's budget. This paper reveals the facts and discloses the fables about how the state spent $34 billion in the 1980s, and it assesses how those facts will make budget cutting tough. The analysis is in three parts: (1) The Prudhoe Bay Ride; (2) Myths and Realities; and (3) Between a Rock and a Hard Place. One table and 10 figures outline the fiscal history of Alaska's oil-rich years and project its future. (ALL)

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Facts and Fables of State Spending

Alaska's state government was suddenly and surprisingly rich in the early 1980s. We quickly learned to spend rich. And the best part about our overnight wealth was that it came at virtually no cost to us as individuals.

Not only did oil revenues from Prudhoe Bay development pay the bill for almost all state operations over the past decade, there were enough revenues left over to pick up some of the costs of local governments, repeal state personal income taxes, create a huge state savings account, and pay all Alaskans annual cash dividends.

Now we're facing the reality of much smaller petroleum revenues in the next decade—see the adjacent box. Many Alaskans think cutting the state budget will be fairly easy: we'll just "cut the fat" that bloated the budget in the 1980s.

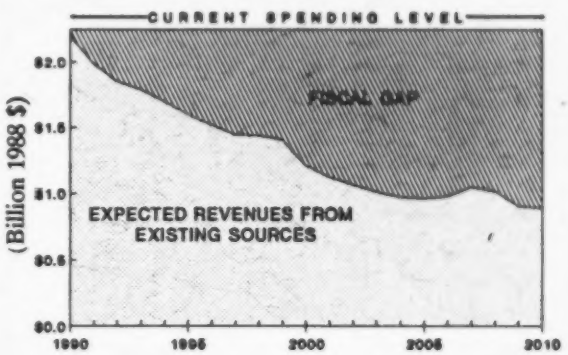
But as we'll make clear in this analysis, cutting the budget will by no means be easy. What some Alaskans regard as spending for "fat" others see as spending for essential services or entitlements. Many things contributed to the high spending of the past decade, and whatever is cut from the budget will hurt some Alaskans.

To make budget decisions, Alaskans need to know how the state actually spent its money in the 1980s. Many of the facts about high state spending have become obscured by fables about where the money went. This paper reveals the facts and discloses the fables about state spending in the 1980s and assesses how those facts will make budget cutting tough.

One important point that tends to get lost in all the talk about big spending is that even *before* Alaska was oil rich, our state government spent two to three times the average of other states. So the increased state spending fueled by oil revenues over the past decade started from a base that was already substantially above that of other states.

Also bear in mind that Alaska's population

PROJECTED STATE FISCAL GAP*
(Difference Between Revenues and Current Spending)



Adjusted for inflation, state government revenues from existing sources will drop 50 percent between now and 2000, leaving a difference of $1 billion between current spending and existing revenues. That substantial gap can only be closed by spending cuts, tax increases, use of reserves, or some combination of the three.

This is the second in a series of ISER Fiscal Policy Papers examining aspects of state government spending. We intend these papers to focus the attention of state officials and of Alaskans in general on the serious budget crisis we face, and on the necessity for dealing with it soon.

The authors are Oliver Scott Goldsmith, Lee Gorsuch, and Linda Leask. Teresa Hull prepared the graphics, and Alexandra Hill and M.L. Madden helped analyze the data.

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Scope of Analysis

Much of our analysis is just of state spending, but we also look at local spending when appropriate. In Alaska the state often provides or pays for services that local governments provide for themselves in other states, without state aid. The fortunes of Alaska's local governments are very strongly tied to those of the state.

One final note that may be helpful in setting the stage for our spending analysis: *there is no absolute measure of what government ought to spend.* Generally, governments spend what citizens are willing to pay in taxes. Wealthier states spend more than poorer states. In this paper we compare Alaska's spending over the past decade with its own previous spending levels and patterns and with national averages. We aren't implying that those two comparisons should be the basis for determining future Alaska spending levels. Rather, we use these comparisons to help put Alaska's 1980s spending in some perspective and to help state officials and Alaskans in general think about what they want to accomplish with the more modest level of resources that will be available in the future.

doubled between 1967 and 1987, and inflation nearly tripled prices. Those factors together mean state spending would have to be six times larger today just to keep pace with population and prices. But state spending in 1987 was 16 times greater than in 1967 – a much larger increase than can be accounted for by the combination of population growth and inflation.

The gap between Alaska state spending and the average for other states widened dramatically in the 1980s. Because Alaska had more money to spend it: (1) expanded existing programs; (2) delivered services in more expensive ways; (3) added many new kinds of spending; and (4) increased wages of public employees.

Those changes in state spending created economic and political forces that will complicate every step toward balancing the state budget. Among the many factors state officials will have to contend with are the importance of state money to individuals, municipalities, school districts, and the entire Alaska economy; the power of interest groups; the popularity and economic importance of the Permanent Fund dividend program and other special benefits; and the unwillingness of Alaskans to pay more taxes.

Our analysis is in three parts: (1) The Prudhoe Bay Ride – the source of big state spending; (2) Myths and Realities – perspectives on state spending; and (3) Between A Rock and A Hard Place – the difficulties associated with budget cutting.

The Prudhoe Bay Ride

The State of Alaska had a tremendous stroke of good fortune in 1968, when oil companies discovered the 10-billion barrel Prudhoe Bay field on state-owned lands on the North Slope. Development of that single oil field – the largest ever discovered in North America – became responsible for several of the state's economic booms, culminating with the biggest in the 1980s.

Figure 1 shows the Prudhoe Bay ride – petroleum revenues the state has collected, largely from the Prudhoe Bay field – over the past 25 years. The figures are in 1988 dollars – which eliminates the effects of inflation and allows us to compare the buying power of revenues each year during that period.

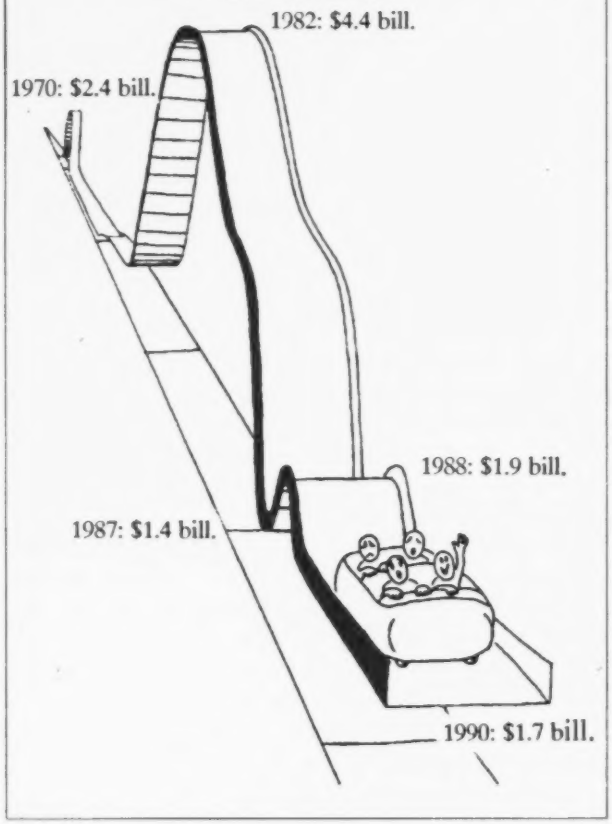
The state leased the Prudhoe Bay field to oil companies in a series of sales in the 1960s. The final sale, in 1969 (fiscal 1970), brought the state its first big petroleum revenues: $900 million ($2.4 billion in 1988 dollars). After that sale, Alaska's petroleum revenues returned to modest levels until the mid-1970s, when construction of the trans-Alaska pipeline to carry Prudhoe Bay oil was nearly complete. Taxes on Prudhoe Bay oil reserves and petroleum-related facilities sharply boosted state revenues in 1976.

In 1977 oil started flowing through the pipeline, and the state began collecting taxes on and royalties from North Slope production. Soon thereafter the world price of oil tripled. This tremendous increase in oil prices made the State of Alaska wealthy overnight. In just two fiscal years state revenues tripled, and by fiscal 1982 the state collected $4.1 billion (or about $4.4 billion in 1988 dollars) in petroleum revenues.

After 1982 oil prices began to slide. Nonetheless, through 1985 state petroleum revenues still exceeded $3 billion a year. Then came the 1986 oil price crash. In fiscal 1987 petroleum revenues were slashed to just a third of what they had been in 1985. Oil prices and, correspondingly, state petroleum revenues, recovered somewhat after 1986. Still, for the past few years the state's annual oil revenues have been only about 40 percent of what they were in the peak year of fiscal 1982.

Driving Alaska's fiscal problem is the fact that expected revenues from existing sources will con-

Figure 1. Alaska Petroleum Revenues Selected Fiscal Years 1965-1990
(In 1988 Dollars)



tinue to slide, as production from Prudhoe Bay declines. By 2000, real petroleum revenues are projected to be just about half of what they are today.

Myths and Realities

What did the state do with its petroleum revenues in the 1980s? Below we expose the myths and discuss the realities surrounding big state spending by analyzing it in two ways. First we describe overall state spending from fiscal years 1981 through 1988 (figures for fiscal year 1989 are not yet available) and identify where the money went and which organizations or individuals benefitted from it. We then examine the much-discussed higher Alaska per capita spending, showing where and why it differs so much from the national average. In the course of our discussion we debunk some commonly held myths.

Total State Spending, Fiscal Years 1981-1988

Figure 2 shows that a whopping $34 billion (or around $36 billion in 1988 dollars) passed through the state general fund from fiscal years 1981 through 1988 – an average of about $4 billion a year.

That $34 billion includes not only operating and capital spending but also some savings and investments. The money went for many purposes inside and outside the traditional purview of government. The list below reveals that not only did government programs benefit from the revenue bonanza but so did schools, municipalities, public corporations, non-profit groups, and – not least of all – individuals. In fact, two-thirds of the total $34 billion went for purposes other than state agency spending. In order of amounts received, the recipients of the state's largess were:

1. *State Agencies*: State agencies themselves spent about a third of the $34 billion for their own operating and capital expenses.

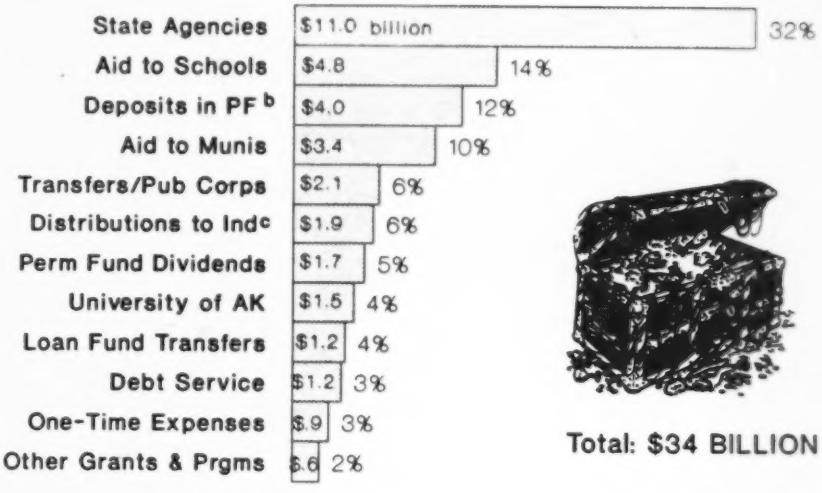
2. *Aid to Schools:* Alaska's urban and rural school districts got 14 percent – nearly $5 billion – of the total. That includes operating and capital aid and reimbursement for school construction debt.

3. *Deposits in Permanent Fund:* Not all of the $34 billion was spent. The legislature deposited $2.7 billion of general fund money and another $1.3 billion from the Undistributed Income Account into the Permanent Fund. These deposits of more than $4 billion accounted for 12 percent of total spending and were in addition to $2.8 billion that went directly into the Permanent Fund as required by the Alaska constitution.

4. *Aid to Municipalities:* Alaska's local governments were on the receiving end of about $3.4 billion in state operating and capital aid – about 10 percent of the $34 billion. State grants for capital projects were by far the biggest part of that aid.

5. *Transfers to Public Corporations:* The state's public corporations – which are quasi-state agencies that do everything from subsidize home mortgage interest rates to build dams – received

Figure 2. Total State Spending[a]
FY1981-1988



[a] Consists primarily of general fund expenditures, but also includes some transportation and education expenditures from other funds and $1.3 billion transferred from the Undistributed Income Account to the principal of the Permanent Fund.

[b] In addition to the Permanent Fund deposits mandated by the Alaska constitution.

[c] Excluding Permanent Fund Dividends.

more than $2 billion, or 6 percent, of the $34 billion. These transfers to public corporations represent an investment, increasing the assets of the corporations. It is beyond the scope of this analysis to determine the current value of those investments. While there have been some significant investment losses, the corporations continue to hold substantial state-financed assets.

6. *Distributions to Individuals:* Individual Alaskans collected nearly $2 billion – or 6 percent – of the total in cash or services through programs *other* than the Permanent Fund dividend program. Included among these distribution programs are the state's welfare programs, the Longevity Bonus program, and others.

7. *Permanent Fund Dividend Program:* This program alone paid Alaskans nearly as much as all the other state distribution programs combined in the 1980s – $1.7 billion between fiscal years 1983 and 1988. Distributed dividends amounted to 5 percent of the total $34 billion in expenditures.

8. *University of Alaska:* The statewide university system received $1.4 billion in operating and capital funds from 1981 through 1988. That is about 4 percent of total state spending during that period.

9. *Transfers to Loan Funds:* Funds that loaned money to students, farmers, fishermen, and others received $1.2 billion, or 4 percent, of state general fund money between 1981 and 1988. This money did not represent straightforward spending, because the state expects recipients to re-pay the loans. However, the amount that may ultimately be available to the state for other purposes is uncertain.

10. *Debt Service:* Debt service on just state general obligation bonds – excluding massive bonded debt held by the state's public corporations – cost Alaska about $1.2 billion, or about 3 percent, of total spending in the 1980s.

11. *One-Time Expenses:* One-time special expenses cost the state about 3 percent of the $34

Measuring State Spending

Reports of government spending often don't match. That happens because there are many ways to measure government spending. Among the most common measures are:

Appropriations: An appropriation is an amount government officials have approved for spending, but haven't actually spent.

Expenditures: An expenditure is an amount dispensed from a government account. Expenditures are mostly amounts actually spent, but they can also include amounts that are simply transferred from one government account to another.

Outlays: An outlay is an amount that actually leaves all government accounts.

Here's an example to illustrate differences in these three measures. A state *appropriation* for local government assistance becomes a state *expenditure* when the funds are transferred to local governments. Those transfers to local government become government *outlays* only when the local governments actually spend the money for intended purposes.

The timing of spending is an important difference among these three measures. Most operating expenditures and outlays do occur in the same fiscal year they are authorized by appropriations. However, the lag between some appropriations and expenditures can often exceed a year, particularly for capital projects, and the delay between expenditures and outlays can also be long. For example, in the early 1980s the state appropriated such large amounts for capital projects that it was impossible to expend it all in the year in which it was appropriated. Another kind of complication is that an amount the state records as an expenditure may not show up as an outlay. In the early 1980s, for instance, the state legislature appropriated $2.7 billion to the Permanent Fund, and that transfer was recorded as a state expenditure. But it has never become an outlay because the money is still in the Permanent Fund. Another difference in the measures is that appropriations don't always result in expenditures – because there may be a shortfall of revenues or a change of policy.

What We Use: In this paper we use both government expenditures and outlays, because using two measures gives us a more complete picture of Alaska state and local government spending.

We use ISER's own calculations of total state general fund expenditures during the 1980s, to provide a full picture of where about $34 billion went from fiscal years 1981 through 1988. Not all of that money became outlays – some went for special appropriations to the Permanent Fund, some went to public corporations, and some went to loan funds. More detailed information on these expenditures is available in the ISER publication *Alaska Review of Social and Economic Conditions*, "Where Have All the Billions Gone?" (February 1987) and the update, *Research Summary* No. 41 (February 1989).

The second source we use is the U.S. Department of Commerce's record of state and local outlays, reported annually in *Governmental Finances*. That source allows us to compare outlays of Alaska's state and local governments with those of other states. Virtually all comparisons of spending among states use this source. Because some aspects of Alaska spending are difficult to compare with national averages, we have made some adjustments in the figures to make the comparisons more accurate. The major adjustment we made was to exclude from outlays the very large interest payments on bonded debt of public corporations – for Alaska, this is primarily debt of the Alaska Housing Finance Corporation. In the federal reports, these interest payments are not identified as being paid from funds of the corporations. Including these interest payments – which do not come out of general revenues – distorts spending comparisons both with previous Alaska levels and with national averages.

billion. The biggest of these expenses were a $295 million payment the state owed Alaska Native corporations, and $160 million refunded to individual Alaskans when the personal income tax was repealed.

12. *Miscellaneous Grants and Programs:* Nonprofit corporations and others providing various kinds of services collected around $600 million, or 2 percent, of total spending from 1981 through 1988. (Such organizations received additional state money through state agencies as well.)

Spending and Employment Changes, 1967-1987

Now that we've seen how much of total spending went to various recipients in the 1980s, we refute some spending myths by looking at changing levels and compositions of state and local spending and employment over the past 20 years.

Figure 3 is a complex graphic that shows several things about Alaska spending per capita relative to the average of other states in 1967, 1977, and 1987. The figure tells us: (1) how much more we spent than the U.S. average in each of those years; (2) how much Alaska's higher costs contributed to those differences; and (3) how the

composition of the extra Alaska spending changed over time.

Because Figure 3 is complex, we use Table 1 to help clarify the information it presents. Table 1 simply repeats the U.S.-Alaska spending ratios and the changing composition of Alaska's extra spending from 1967 through 1987—so the reader can more readily see the changes.

The bars for each year in Figure 3 show total Alaska per capita state spending—so, for example, in 1967 Alaska's state government spent $742 per resident. The bottom portion of the bar shows the average spending per capita among all states—again, in 1967, the U.S. average per capita spending among state governments was $265.

To find the difference between Alaska and U.S. average state spending, we could just divide $742 by $265—which would indicate that Alaska state spending was 2.8 times the national average that year. This is the unadjusted ratio of Alaska to U.S. average spending per capita. But because we know that costs in Alaska are higher, we need to subtract that portion of Alaska spending that goes just to pay higher costs, so we can compare real buying power.

The part of the bar just above the U.S. average, labeled COLA (cost-of-living adjustment), is the portion of Alaska state spending we estimate is necessary to buy in Alaska the same bundle of goods and services state governments in the Lower 48 provide. If Alaska only provided the same things other state governments provide, that would be the only cost adjustment we would have to make.

We know, however, that Alaska's state government provides things other states don't—and those extras (labeled "Extra Spending" on the bars) also cost more to buy here than they would in other states. So we make a second cost adjustment—which is that portion of the Alaska-U.S. differential that the state spends just because the extra goods and services it provides cost more here than they would in other states. That second cost adjustment (COLA) is shown at the top of the bar.

This adjusted measure of how much government Alaska provides offers the better comparison, because it leaves out the differences that are solely due to Alaska's higher prices. With the two cost-of-living adjustments, we can see that Alaska state spending in 1967 was 1.8 times the national average—($742-$117-$141)/$265 = 1.8.

Although a single year can't perfectly reflect the spending pattern of a decade, we picked 1967 and 1977 to contrast with 1987 because those earlier years show spending before Prudhoe Bay was discovered and during the pipeline construction boom. While spending was somewhat lower in 1987 than it had been earlier in the decade, we believe it still provides a good representation of spending in the 1980s. (Comparable figures for 1988 and 1989 are not yet available.)

In addition to Figure 3 and Table 1, we use Figures 4 through 9 to tell a story: the story of what happened to state and local spending over the last 20 years.

Text continued on page 8.

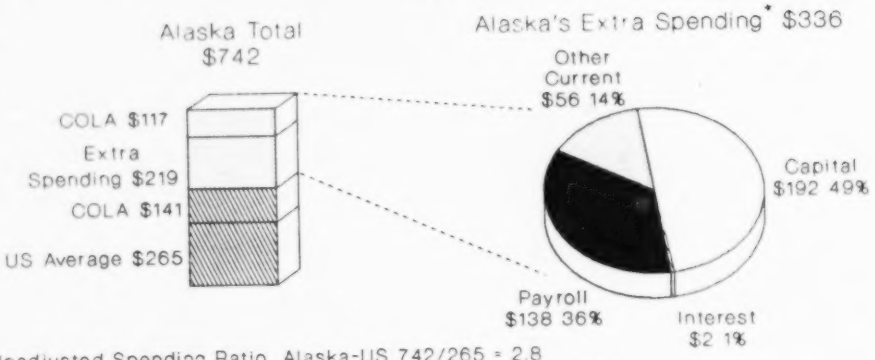
Table 1
Per Capita Alaska State Spending Compared to U.S. Average

Fiscal Year	Unadjusted Spending Ratio	Adjusted Spending Ratio	Composition of Extra Spending					
			Capital	Payroll	Other[a]	Local Transfers	Interest	Permanent Fund Dividend
1967	2.8	1.8	49%	36%	14%	0[b]%	1%	0%
1977	3.1	2.1	34	36	19	6	4	0
1987	4.0	3.1	12	23	25	23	1	16

[a]Other current expenses include spending for programs unique to Alaska and extra spending for programs common to other states.
[b]In FY67 Alaska spent 30% less on transfers to local governments than the average of other states.

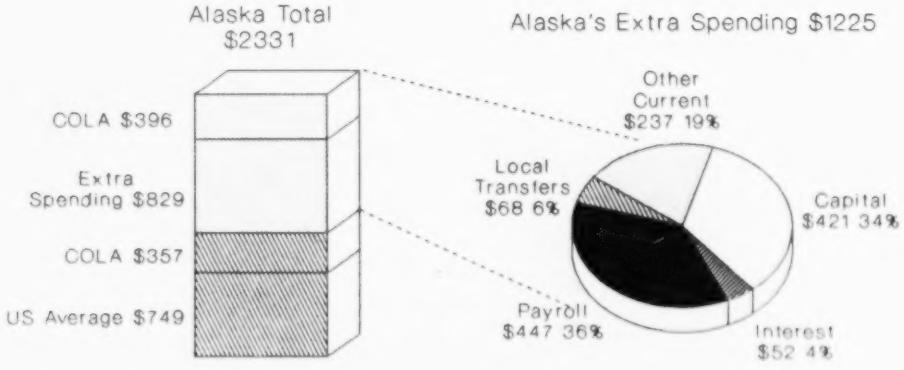
Figure 3. Composition of Alaska State Spending Per Capita
(Nominal Dollars)

1967



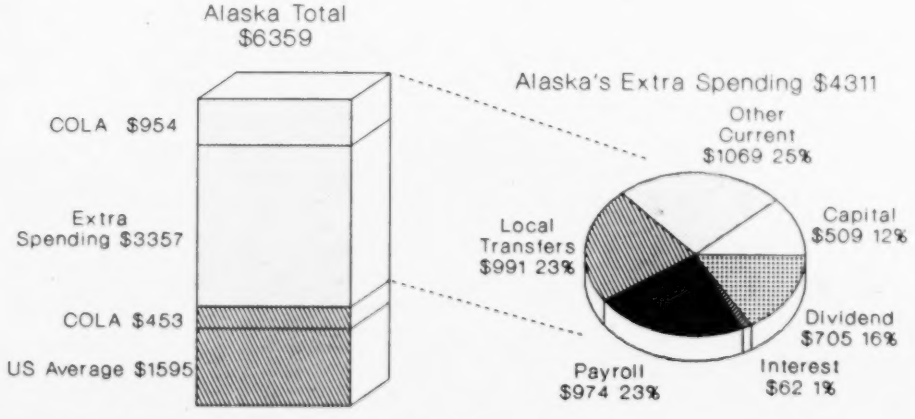
Unadjusted Spending Ratio, Alaska-US 742/265 = 2.8
Adjusted Spending Ratio, Alaska-US (742-117-141)/265 = 1.8
* Components exceed total since local transfers were $52 below US average.

1977



Unadjusted Spending Ratio, Alaska-U.S. 2331/749 = 3.1
Adjusted Spending Ratio, Alaska-US (2331-396-357)/749 = 2.1

1987



Unadjusted Spending Ratio, Alaska-US 6359/1595 = 4.0
Adjusted Spending Ratio, Alaska-US (6359-954-453)/1595 = 3.1

The Alaska Cost-of-Living Adjustment (COLA)

All our numbers are in 1988 dollars, except those in Figures 2 and 3. That adjustment eliminates the effects of inflation so we can assess real changes in spending over time.

Also, in Figures 4, 5, 6, and 9, we've added an Alaska cost-of-living adjustment (COLA) to the U.S. average numbers. That adjustment takes into account Alaska's higher living costs and shows what the U.S. averages would be at Alaska prices. We also used this COLA in Figure 3 to determine how much of per capita Alaska spending is required just to compensate for Alaska's higher prices.

Our cost-of-living adjustment takes into account both the higher cost of living in Anchorage relative to the U.S. average, and the higher cost of living in other Alaska regions relative to Anchorage. The 1988 COLA is 24 percent, and is based on a 15 percent differential between Anchorage and U.S. average prices, multiplied by an 8 percent differential between Anchorage and other Alaska prices. So, a commodity that costs $1.00 in the U.S. as a whole will cost $1.15 in Anchorage and $1.24 in the typical Alaska community. We calculated the Anchorage-U.S. differential with U.S. Bureau of Labor Statistics information. Our calculation of the differential between Anchorage and the rest of the state is based on the regional cost-of-living indexes reported in the *Alaska Geographic Differential Study* (prepared for the Alaska Department of Administration in 1985 by The McDowell Group), weighted by the proportions of state and local government employment in each region.

No cost-of-living adjustment is perfect. This one applies most appropriately to personal consumption and less so to the costs of construction. We know the relative cost of construction in Alaska is higher than the relative cost of labor – and higher construction costs in turn increase the overall costs of government. But since labor costs are such an important component of government costs, this COLA is an appropriate measure of a large part of the budget.

Text continued from page 6.

Some of the commonly held spending myths are:

Level of State Spending

Myth: Alaska state spending only soared above average spending among other states during the past decade.

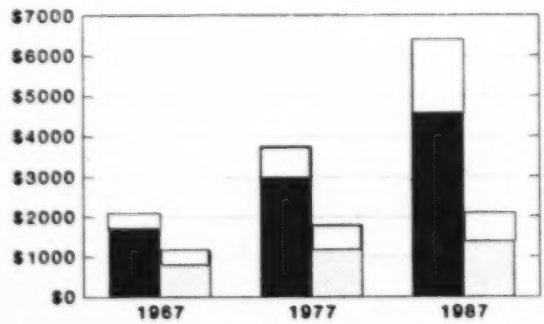
Reality: Alaska's spending has historically been far above the national average. True, the gap did widen dramatically in the 1980s – but it started from a relatively high base.

With no adjustment for living costs, state spending per capita in 1967 was 2.8 times the national average. Adjusted for Alaska's higher costs, that 1967 ratio was 1.8. (Figure 3). By 1977 the unadjusted ratio of Alaska spending to the average of other states had increased to 3.1, and the cost-of-living adjusted ratio was 2.1.

By 1987, unadjusted Alaska spending per capita had jumped to 4 times the national average; that ratio dropped to 3.1 times the national average with a cost-of-living adjustment. Overall, taking living costs into account, the gap between Alaska and U.S. average state spending increased moderately between 1967 and 1977 and then jumped from 2.1 to 3.1 times the national average between 1977 and 1987.

Figure 4 shows that real Alaska per capita spending – minus the effects of inflation – tripled between 1967 and 1987, with the fastest growth in

Figure 4. State Spending Per Capita Alaska and U.S. Average (In 1988 Dollars)



	1967	1977	1987
With Transfers to Local Government			
Alaska	$2091	$3757	$6383
US Avg	$1143	$1781	$2057
Ratio	1.83	2.11	3.10
Without Transfers to Local Government			
Alaska	$1831	$2981	$4651
US Avg	$738	$1115	$1319
Ratio	2.48	2.67	3.53

Alaska | US Avg | Transfers to Local Govt.

Note: U.S. averages are inflated by Alaska COLA.

the last decade. Alaska's spending growth far outpaced the rate among other states – even though the U.S. average increased a substantial 80 percent in that same period. The U.S. averages in this figure and in several later figures are cost-of-living adjusted; see the text box for an explanation of what that means and why we use that adjustment.

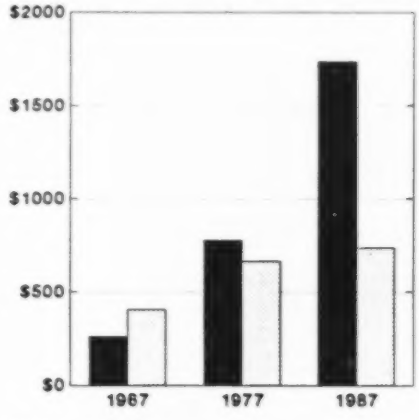
The four graphs in Figure 5 show how selected components of state spending per capita changed over those 20 years. The sharpest increase in spending per capita was in transfers to local governments, which grew nearly sevenfold from 1967 to 1987. Spending for other current expenses (see note to Table 1) was also up dramatically – nearly fivefold. Payroll spending per capita doubled. Capital spending per resident, which in 1967 was highest relative to the national average, remained near the same level in 1987.

Figure 5. Changes in Selected Components of State Spending Per Capita
(In 1988 Dollars)

Other Current Spending Per Capita

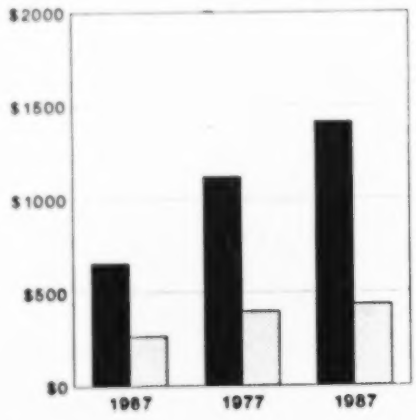
	1967	1977	1987
Alaska	$370	$889	$1750
US Avg	$212	$506	$677
Ratio	1.75	1.76	2.58

Local Transfers Per Capita



	1967	1977	1987
Alaska	$260	$776	$1732
US Avg	$405	$666	$738
Ratio	0.64	1.17	2.35

Payroll Spending Per Capita



	1967	1977	1987
Alaska	$652	$1116	$1409
US Avg	$263	$398	$432
Ratio	2.48	2.82	3.26

Capital Spending Per Capita

	1967	1977	1987
Alaska	$794	$884	$897
US Avg	$253	$185	$188
Ratio	3.14	4.87	3.75

Note: U.S. averages are inflated by Alaska COLA.

Higher Living Costs

Myth: Alaska's higher living costs largely explain why the state spends three times the average of other states.

Reality: As Figure 3 shows, the additional amount Alaska spent to buy the same level of government as in the U.S. as a whole made up only a small part of total Alaska spending each year.

Living costs here have historically been higher than the national average, particularly in rural areas. Today Alaska costs remain higher – but the difference has shrunk over the past 20 years as Alaska markets grew bigger and transportation became more efficient. This change has been reflected in an inflation rate lower than the national average for most of this time. Yet, despite these relative declines, Alaska spending per capita continued to grow rather than decline.

Unique and Expensive Programs

Myth: Alaska's state government provides the same services as other states.

Reality: Alaska provides many programs unlike those in any other state; it spends more for functions common to all the states; and it delivers services in more expensive ways. Together, those factors accounted for close to 40 percent of Alaska's extra spending per capita in 1987. (The sum of "Other Current Expenditures" and the Permanent Fund dividend categories in Figure 3.)

Most of Alaska's unique programs were created or expanded in the past decade. The most obvious of these is the Permanent Fund dividend program, which is so large we list it in a category by itself in Figure 3 and Table 1. Excluding the Permanent Fund dividend program – which alone accounted for 16 percent of extra spending – special Alaska programs, methods of delivery, and the "Alaska Factor" described below accounted for most of the "Other Current Expenditures" shown in Figure 3, which made up 25 percent of the extra Alaska spending in 1987.

In 1977, "Other Current Expenditures" accounted for about 19 percent of the extra Alaska spending, and in 1967 14 percent. The Permanent Fund dividend program didn't exist in those years.

The Alaska Factor

Myth: Alaska's higher spending is mainly the result of special Alaska conditions not captured in a cost-of-living adjustment.

Reality: The conditions that have historically driven up government costs here – Alaska's huge size, widely scattered communities, small population, and harsh climate – still contribute to high service delivery and construction costs in the 1980s. But we would expect these factors to play a smaller role in state spending than they used to, because capital spending as a proportion of total state spending has declined sharply while transfers to individuals have increased substantially.

The cost of the "Alaska Factor" is included in "Other Current Expenditures" in Figure 3.

Transfers to Local Governments

Myth: Alaska's local governments became financially more independent in the 1980s as their tax bases grew.

Reality: Tax bases of urban governments in Alaska did increase sharply in the first half of the 1980s, but at the same time they cut tax rates, expanded services, and became more dependent on state aid. Transfers to local governments accounted for 23 percent of Alaska's extra spending in 1987, as compared with 6 percent in 1977. In 1967 transfers to local governments were below the national average, and do not appear in Figure 3.

Figure 6 shows that real per capita local spending (minus the effects of inflation) quadrupled between 1967 and 1987. That big increase in spending was attributable to two major factors: fast growth in local tax bases, particularly in Anchorage and other urban areas, which boosted local property tax revenues even as tax rates were being reduced; and sharp increases in state aid.

Figure 6 also shows that in 1967 real per capita spending by Alaska local governments was 30 percent below the national average and by 1977 just 10 percent above. By 1987, however, per capita spending by Alaska local governments was nearly double the average of other local governments. The pie to the left of the 1987 bars in Figure 6 shows what the extra spending (above the national average) was for: half was for capital

projects; 25 percent was for payroll costs; 13 percent was for interest on bonded debt; and the final 11 percent was for a variety of other current expenses.

An increasingly expensive function for local jurisdictions in recent times has been elementary and secondary education. Prior to the 1970s, the costs of public education for Alaska's Native population were borne primarily by the federal government. Locally controlled Regional Education Attendance Areas (REAAs) were created to operate the dozens of new schools built throughout rural Alaska in the 1970s and 1980s, and the former Bureau of Indian Affairs (BIA) schools that were transferred to the state. The state pays all the costs of those rural districts, and more than two-thirds of the costs of urban ones. The state also reimburses school districts for 80 percent of the principal and interest costs on bonds sold to finance school construction. Finally, also adding to the increased cost of schooling in Alaska in the 1980s was the fact that school-age children made up an increasing proportion of the population.

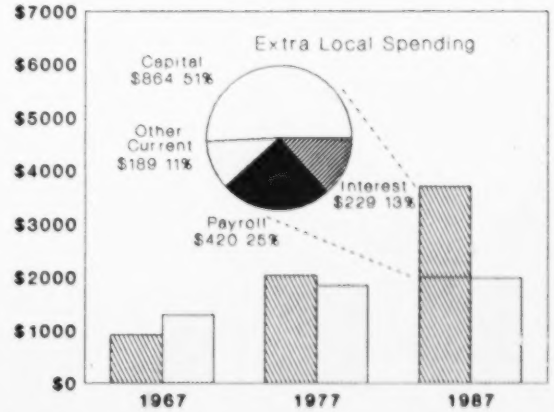
More Workers and Higher Pay

Myth: Alaska spending is high mainly because the government has too many workers who are paid too much.

Reality: Alaska's payroll costs – determined by the number of workers and their pay – accounted for 25 percent of Alaska's extra spending in 1987, which was less than the 36 percent payroll costs contributed in 1967 and 1977. That means fast growth in overall state spending outpaced growth in payroll spending.

Even though the *proportion* that payroll contributed to higher costs declined, the *per capita spending* for state payroll increased sharply from 1967 to 1987. (Figure 5.) Real per capita spending (minus the effects of inflation) for payroll costs more than doubled between 1967 and 1987. (The benefits portion of personnel costs appear in the "Other Current Expenditures" category in Figure 3.)

Figure 6. Local Spending Per Capita Alaska and U.S. Average (In 1988 Dollars)



Note: U.S. averages are inflated by Alaska COLA.

Myth: State employment is a lot higher than it used to be.

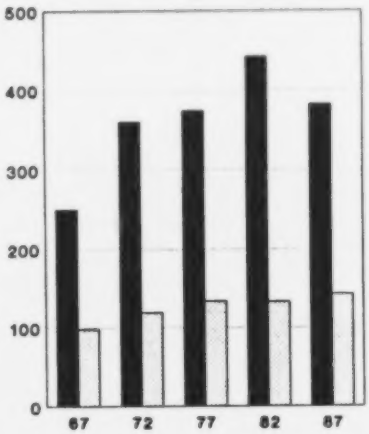
Reality: Yes and no. As Figure 7 shows, there were about 50 percent more state workers per resident in 1987 than there were in 1967 – 382 workers per 10,000 residents as compared with 250 per 10,000 residents. So yes, Alaska did add a lot of state workers over the past 20 years.

But notice that in 1987 the ratio of Alaska workers to the U.S. average was about the same as it had been in 1967. In both years, Alaska had about 2.6 times the national average of state workers per 10,000 population. State employment intensity peaked in the early 1980s at the height of the state spending boom, but declined about 14 percent between 1982 and 1987.

In part Alaska has always had more workers per capita because that is the nature of sparsely populated states; delivering services requires a certain number of government workers, whether the population is relatively larger or smaller. Also, the state government here has traditionally provided a number of services that in other states are provided by local governments. However, state employment per resident did not decline as local government employment increased, as we might have expected. Nor did economies of scale associated with the state's large population growth over the past 20 years become apparent.

Myth: Local government employment soared along with local government spending in the 1980s.

Figure 7. State Government Jobs* Per 10,000 Population



	67	72	77	82	87
Alaska	250	360	374	442	382
US Average	98	119	134	133	143
Ratio	2.55	3.02	2.79	3.32	2.67

Alaska US Average

*Jobs are full-time equivalent.

Reality: Local government employment did increase 70 percent between 1967 and 1987 (Figure 8.) But during the same period local spending quadrupled. (Figure 6.) So it's clear that much of the bigger local spending went into capital projects and other things that did not require as many new workers. Also, as we mentioned above, the rural school districts known as Regional Education Attendance Areas (REAAs) were established in the 1970s. Some of the new local employment in rural areas is school employment.

Notice that in 1967 Alaska local employment was 25 percent below the average for other states: Alaska had 217 local workers for every 10,000 residents, as compared with the national average of 287. By 1987, Alaska local employment—despite vigorous growth—was still just 4 percent above the national average: Alaska local jurisdictions had 368 workers per 10,000 population, as compared with the average of 353 for local governments elsewhere. Local employment intensity in Alaska was higher in the early 1980s, but declined about 3 percent between 1982 and 1987.

Part of the reason why Alaska local employment in the 1980s is so close to the national norm, while state employment is so much higher, is that even today many areas of rural Alaska have only minimum local government structures, and the state and federal governments provide numerous local services.

Myth: State government wages are just high enough to cover Alaska's higher living costs.

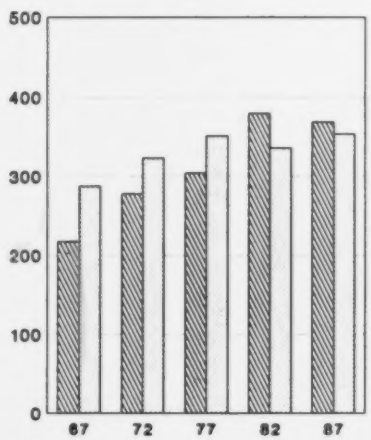
Reality: State government wages more than compensate for higher living costs. Figure 9 shows that in 1987, even after adjusting for Alaska's higher costs, state workers on average earned 25 percent more than state workers elsewhere.

In the 1960s, by contrast, when Alaska living costs were much higher relative to the national average, higher Alaska government wages did just about cover higher living costs. By 1977, real Alaska government wages had moved to about 8 percent above the national average.

Part of the reason why Alaska state wages in 1987 were above the national average is that there were substantial wage increases over the past 20 years. But those increases came mainly at two times: during the pipeline boom of the mid-1970s, and during the peak of the state spending boom in the early 1980s.

The severe Alaska recession in the late 1980s has held down government wages. But Alaska state workers are still doing better relative to state workers elsewhere because the recession also held down prices here. So in the past few years inflation in Alaska has been lower than the national rate, and buying power in Alaska has not

Figure 8. Local Government Jobs* Per 10,000 Population

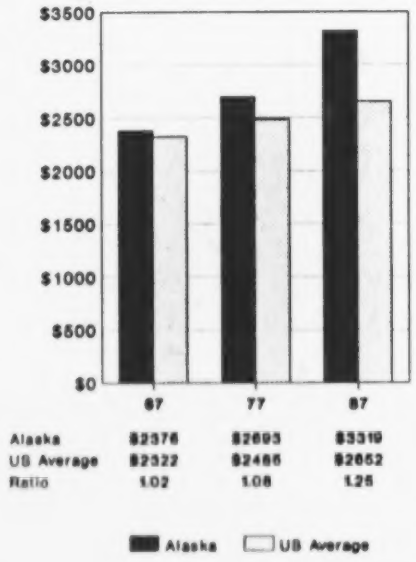


	67	72	77	82	87
Alaska	217	278	304	379	368
US Average	287	323	351	335	353
Ratio	0.76	0.86	0.87	1.13	1.04

Alaska US Average

*Jobs are full-time equivalent.

Figure 9. State Government Wage*
(In 1988 Dollars)



*Average October earnings, full-time employees; excludes benefits.
Note: U.S. averages are inflated by Alaska COLA.

been eroded as much. Alaska's relatively high wages are of course not confined to government and are in large part the legacy of numerous economic booms.

Permanent Fund Dividend Program

Most Alaskans know that their annual dividends come from the earnings of the Permanent Fund.

What they may not realize is that in calculating the difference between Alaska and national average spending, the federal government counts the dividend payments as part of state spending. In 1987 those payments accounted for 16 percent of Alaska's extra spending. The program did not exist in 1977 or 1967. Whether we want to admit it or not, Permanent Fund dividends are a new and major source of state spending.

Capital Spending

Myth: Alaska can develop its infrastructure without adding to the costs of government.

Reality: Capital spending, like other kinds of spending, adds to Alaska's higher costs of government. It increases cash outlays and indebtedness, and usually adds other costs for operating and maintaining the new facilities and improvements.

In 1967, overall state spending was much lower than it is today, and at that time capital spending accounted for half of Alaska's extra spending per capita. By 1977 this capital spending accounted for about a third of the extra. But in 1987, a year when the state capital budget was smaller compared with the other spending components, capital spending added just 12 percent to Alaska's higher per capita costs. What does not show up here, but which we know did happen in the 1980s, is that capital spending by local governments—with state grants—replaced some state capital spending.

A less obvious cost of capital spending is operating and maintaining the new facilities after they're constructed. Since Alaska does not build the cost of operating and maintaining new and improved capital stock into the cost of construction, it is not surprising that those operation and maintenance costs also push up the state budget. Those higher operation and maintenance costs (unless they are deferred) show up as part of the growing "Other Current Expenditures" category in Figure 3 and Table 1.

Myth: Alaska paid as it went for capital projects, and therefore did not incur much new debt in the 1980s.

Reality: That would appear to be true, if we look only at the fact that interest on general obligation bonds contributed just 1 percent to Alaska's extra spending per capita in 1987, as compared with 4 percent in 1977 and almost nothing in 1967. (Figure 3.) We know that the state paid outright for hundreds of capital projects in the early 1980s.

However, Alaska's municipalities and school districts incurred a great deal of new bonded debt in the 1980s. The state government pays most of the costs of school debt. Figure 6 shows the extra debt burden of Alaska local governments; some of that debt is paid by state transfers.

And at the same time, the state's public corporations—particularly the Alaska Housing Finance Corporation—were taking on billions of dollars in bonded debt, on which they pay hundreds of millions of dollars a year in interest.

Those interest payments aren't reflected in Figure 3, because they come out of corporation funds rather than general fund revenues. Nonetheless, the good credit of the Alaska treasury stands behind those loans.

Free Government

Myth: Alaskans carry a heavy tax burden for the services we get.

Reality: Alaskans pay low state and local taxes relative to other Americans. Alaska has no state personal income or sales taxes, and local property tax rates—although they have risen in the past few years—are still often lower than they were in the 1970s. Also, Alaskans receive cash payments from the state under the Permanent Fund dividend and Longevity Bonus programs. In many cases, payments Alaskans receive outweigh the state and local taxes they pay.

Finally, the state widened eligibility for a number of programs in the 1980s—so that regardless of need or income, Alaskans could borrow money at below-market rates, get subsidized home mortgage loans, and qualify for a number of other special benefits. The fact that individual Alaskans paid little for government and received handsome benefits from it certainly encouraged big spending growth in the 1980s.

Between a Rock and a Hard Place

The discussion above reveals that there was no single culprit responsible for Alaska's higher spending in the 1980s. And it's apparent that the new and different ways the state spent its money in the past decade have become very important to local governments, school districts, and individual Alaskans, among others. Even if all Alaskans agreed on the necessity for reducing state spending (which not all do) we would still confront difficulties and complexities in deciding how to cut state spending or add taxes to close the projected state fiscal gap. Proponents of budget cuts must consider the following:

1. **Special Interests:** It may be no exaggeration to say that every state expenditure has its constituency and many have lobbyists and PACs (political action committees) as well. Each of these constituencies has very direct and often substantial economic interests in seeing particular kinds of state spending continued. These constituencies organize and devote time, effort, and money to protecting their interests. Collectively, these special interest groups tend to overpower any ill-defined or unorganized public interest in fiscal restraint, including legislative commitment to that restraint.

2. **Economic Dependence:** More than one in four jobs in Alaska can be traced to state and local government spending. Major cuts in state spending will inevitably reduce income and eliminate jobs. And depending on how the cuts are made, some regions of the state will feel the effects more than others. Last winter ISER analyzed for the governor's Office of Management and Budget the potential impacts on the economy of a $350 million across-the-board cut in the state's budget. That report documented the widespread effects of such a cut, and it had a chilling effect on legislative resolve to cut the budget.

3. **Economic Climate:** Alaska's severe recession in the late 1980s took a heavy toll on the economy. We lost jobs and population. Banks failed. Businesses and individuals went bankrupt in unprecedented numbers. Property values plummeted and thousands of homes went into foreclosure. Local governments realized heavy tax losses as property values fell. Having seen such losses in the past few years, Alaskans understandably are not receptive to either reduced aid and services or increased taxes—both of which will reduce income and employment.

4. **Financial Dependencies:** Municipalities came to rely on much higher state aid in the 1980s. The state has already begun to reduce some of that aid; between 1986 and 1988, for instance, the state cut municipal operating aid nearly 30 percent. And even as state aid began to decline, the 1985-88 recession slashed property values and reduced local tax bases. So urban local governments that expanded services and cut property taxes in the 1980s now find themselves with smaller tax bases, less state money, and voters who have refused to approve just about all proposed new taxes. Rural municipalities—most of which have very small or non-existent tax

bases – are in an even more precarious position as state aid drops.

Similarly, urban school districts also came to depend on more state money in the 1980s. The state's school foundation program, which pays most of the costs of urban schools, grew rapidly. Also, the state pays 100 percent of the capital costs of REAAs and reimburses the other school districts for 80 percent of the principal and interest payments they make on bonded debt. State reimbursement of school construction debt mushroomed from $38 million in 1982 to $109 million in 1988. That debt reimbursement is a policy that the state legislature can change any time it chooses. But to do so would transfer the legal obligation to repay that debt to local property taxpayers – who would certainly be unreceptive to such a move.

5. **Unwillingness to Pay:** Alaskans in the 1980s became used to paying low state and local taxes. The state personal income tax, which provided 24 percent of state revenues in 1977, was repealed in 1980, and property taxes were cut in many municipalities in the early 1980s. In the face of falling state aid and reduced tax bases, local governments have raised property taxes in the late 1980s. Still, in 1987 Anchorage residents paid the lowest state and local taxes among big city residents around the country. But coming out of a severe recession and having become accustomed to low taxes, voters have said no to virtually all moves to raise taxes.

6. **Increasing Demands:** Even though Alaska's population declined during the recession, ISER forecasts moderate population growth – one to two percent a year – in Alaska during the 1990s. A growing population will put increasing demands on a shrinking budget. Furthermore, the segments of the population expected to grow the fastest – school-age kids, the elderly, and residents of small, rural places – are also the most expensive to serve. So, while overall population growth will be moderate, groups that are expensive to serve will be growing fast, creating pressure to increase rather than decrease state spending.

There will also be new demands for state services unrelated to population growth. Some will be mandated by the federal government, as is the case under the federal welfare reform requirements. Others will result from developments we can't predict.

Even political pressure to reduce the federal deficit could shift federal program responsibilities on to state and local governments. In fact, such transfers of responsibility have been a fact of life over the past 20 years.

7. **Expensive Service Delivery:** The state in the past decade created some service delivery systems that give local residents more control, but which are also more expensive. For example, before the 1970s, rural Native students who wanted to attend high school had to leave their villages for regional boarding schools. But over the past decade, the state established a whole new system of rural school districts--the Regional Education Attendance Areas (REAAs). Those districts are directed by locally-elected boards but are paid for entirely with state money – and are of course a lot more expensive that the old rural school system. Similarly, creation of a host of local or regional offices and advisory boards for various state programs all contribute to an expensive system of delivering state services in rural areas. However, efforts to re-centralize these services is likely to encounter strong resistance from the affected regions.

8. **Sacred Cows:** The Permanent Fund dividend program, established in 1982, has become in its brief history an important force in the Alaska economy and, in the minds of many Alaskans, an entitlement program. ISER reported in 1989 that Permanent Fund dividends accounted for 7 percent of personal income in rural Interior areas and created more than 2 percent of all jobs in the Alaska economy. Aside from the economic force of several hundred million dollars going into the Alaska economy each year, the dividend program has become to many Alaskans an entitlement program akin to various traditional programs that are – unlike the dividend program – based on need or personal contributions. The Longevity Bonus program, which makes monthly payments to Alaskans over 65, irrespective of financial need, is another popular and entrenched state program. Legislative efforts to tamper with either the Permanent Fund dividend or the Longevity Bonus program have been met with anger and indignation. Other free or low-cost benefits include subsidized loans; capital projects

not financed by general obligation bonds but by direct state grants; and subsidized electric rates for rural residents.

In 1987 the dividend program and other special programs were responsible for something in the neighborhood of 40 percent of the extra spending per capita that Alaska does relative to the U.S. average. Reducing, much less eliminating, these sacred cow programs is likely to be regarded as political suicide.

9. **Contingent Liabilities:** Even while the state was paying outright for hundreds of capital projects, the state's public corporations (most notably the Alaska Housing Finance Corporation but others as well) were taking on billions of dollars in bonded debt. That debt is currently paid for through funds of the corporations. But should the corporations ever be unable to meet their obligations, the creditworthiness of the state would be affected. Eliminating the financial reserves of these corporations to raise current revenues could jeopardize their solvency. Municipal and school debt also represent contingent liabilities.

10. **Wage Reduction Resistance:** Alaskans—including both government workers and many in private industry—have grown used to wages that are higher than the national average, even after an adjustment for Alaska's higher living costs. Despite the downward pressure that the recent recession put on wages, in 1987 Alaska government wages remained 25 percent above the national average, after a cost-of-living adjustment. Even though higher payroll costs are responsible for about a quarter of Alaska extra per capita spending relative to the U.S. average, Alaska's public employees are well-organized and are not likely to willingly accept wage reductions to help reduce state spending.

11. **Easy Cuts Behind Us:** The state has already made what could be called the "easiest" budget cuts—largely cuts in capital spending. It has also cut back on aid to municipalities—which it had increased so much in the halcyon days of the early 1980s. The kinds of cuts the state must now consider are ones that will have a more direct effect on services or benefits.

To challenge the notion that Alaska need not cut state spending but simply raise revenues, the next paper in this series analyzes the history of state revenues and the capacity of the economy to support additional taxes for state and local government.

It is easier to make a suggestion than to carry it out.

Aesop's Fables

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